



Reporting of Retainage Income by Subcontractors

The Internal Revenue Service is seeking to help construction businesses understand the law regarding the proper reporting of “retainage” income. Retainages represent amounts that are due to a subcontractor but retained by the general contractor until such time as the contract is completed. The purpose of the retainage is to provide the owner security for costs incurred to repair defective work, to settle claims from parties not paid by the contractor, and to ensure the work is completed in accordance with the contract. How does the subcontractor account for these amounts for federal income tax purposes? The answer is dependent on the subcontractor’s method of accounting. Common methods of accounting in the construction industry include the cash method, completed contract method, accrual method, and percentage of completion method.

Most small contractors use the cash method of accounting. With this method, the contractor reports income when actually or constructively received and deducts expenses when paid. Such is the case with retainages. If the general contractor keeps the retainage until the completion of the contract, the subcontractor will report the income at that time, i.e., at the time the retainage is received.

The completed contract method of accounting is probably the most common method elected by small contractors. A subcontractor’s work may be completed early in the project, but final payment will not be made until the entire project is complete. If the subcontractor’s work is considered completed and accepted, the completion of the contract and recognition of income cannot be deferred to the date when the payment is received. When the subcontractor’s job is considered completed, he must report the total revenue, even though the final retainage may not be received until much later.

Under the accrual method of accounting, the subcontractor reports the retainage (income) when it is received, due, or earned, whichever comes first. Accrual method taxpayers may ELECT to defer retainages withheld until they are billable; that is, when the contractor has the right to receive the retention amount. If the taxpayer elects to defer, it is a change in method of accounting that requires the Commissioner’s permission. For more information on changing accounting methods, see publication 538.



*IRS - Construction
Center of Excellence*

Some subcontractors with long-term contracts may elect to use the percentage of completion method of accounting. The percentage of completion method recognizes income as the work on the contract progresses. The amount of income that is reportable in each year is that portion of the total contract price that represents the percent of the entire contract completed during that year.

If you have specific questions regarding these tax incentives you may call IRS at 1-800-829-4933 or e-mail the IRS by visiting www.irs.gov.



*Construction
Center of Excellence*

